2007-2012
Capital Bank
OF NEW JERSEY
FIFTH ANNIVERSARY
P.O. Box 690, Vineland, NJ 08362
voice 856.690.1234
capitalbanknj.com

October 19, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Delivered via email regs.comments@federalreserve.gov

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
Delivered via email comments@FDIC.gov

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, DC 20219
Delivered via email regs.comments@occ.treas.gov

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to comment on the proposed Basel III Capital Rules. Thank you also for providing a separate addendum summarizing the NPR for community banks. As president of a $280 million de novo community bank, the proposed rules have significant implications for my bank and many others like it.

There are a number of different comments I could make for the reasons why I believe the idea of imposing this European-born, global-minded framework upon our nation's community banks is a bad one. **However, I have chosen to focus my comments in this letter on the one aspect of the proposed rules which I think is the most misguided: namely, the proposed requirement that unrealized gains and losses on available-for-sale (AFS) securities flow through to regulatory capital.** If the proposed Basel III rules are applied to community banks *at all*, this particular aspect of the rule needs to be removed, for the following reasons.

1. It would introduce a high degree of volatility to a bank's capital position. No credible party questions the importance of a bank maintaining a strong, stable and high-quality capital base. But a direct outcome of the proposed AFS rule would be that a bank's capital position would whipsaw up and down with interest rate swings. That result would run completely counter to the need for stability in capital.

2. The proposed rule would unduly influence investment decisions. What banker will be willing to make five, ten, or fifteen-year duration investment selections, *even if that is what his or her bank's IRR analysis shows is appropriate and necessary*, knowing that unfavorable interest rate swings will result in an immediate regulatory capital charge? An unintended but direct consequence of this rule would be the shortening of the duration of a bank's AFS portfolio, causing banks that are already asset-sensitive to become even more so. While the regulatory agencies have recently emphasized their concerns about the need for banks to be ready to manage robust up-rate scenarios[1] – and understandably so – it is also true that the potential of a protracted low and flat rate cycle is a very possible one for which banks must plan, and it contains equally dangerous NIM implications. The influence of shortening a bank's AFS investment portfolio would exacerbate such risk.

3. Not only is it misguided to reduce regulatory capital based on an upward interest rate cycle, it is equally misguided to *credit* capital in a downward one. At my bank, Capital Bank of New Jersey, we currently have an AFS accumulated other comprehensive income (AOCI) of about $1.5 million. I believe it would be foolish for us to count on that accounting entry as regulatory capital, knowing it can quickly evaporate in an up-rate scenario. I also believe it would be imprudent for a regulator to give my bank credit for it – but that is what the proposed rule would do.

4. It would essentially compel banks to make immediate and large-scale reclassifications of AFS securities to held-to-maturity (HTM) status to avoid the regulatory capital risk. By doing so, very large sums of investments will no longer be available to meet those banks' liquidity needs via sale. Therefore, banks will wind up avoiding the regulatory capital risk by "trading it" for increased liquidity risk.

5. Singling out this effective mark-to-market accounting for AFS investments only, and not for any of a bank's other assets or liabilities, is inconsistent. It is true that, as interest rates rise, the fair market value of fixed rate investments goes down. However, it is also true that as interest rates rise, the value of other balance sheet categories, such as core transactional deposit accounts, goes up. A rule that results in a regulatory capital charge when the fair market value of one asset goes down, but not when other assets or liabilities go up, makes no sense.

[1] E.g., FDIC FIL-2-2012

6. We already have the other-than-temporarily-impaired (OTTI) accounting treatment for investments whose fair market values may be *permanently* impaired. In such cases it is *appropriate* that regulatory capital is marked down to fair market value. No new rule is needed to address such true impairments.

7. As noted in the Federal Reserve's Examination Manual, accepting an appropriate amount of interest rate risk "is a normal part of banking and can be an important source of profitability and shareholder value."[2] It should not be unduly discouraged by attaching the threat of unpredictable regulatory capital swings.

I urge you to reconsider the wisdom of applying the proposed Basel III rules to our nation's community banks at all. If these rules *are* applied to community banks, the AFS aspect of the rule needs to be removed.

Sincerely,

David J. Hanrahan, Sr.
President and CEO

cc: The Honorable Frank R. Lautenberg
c/o Emily Winchatz, emily_winchatz@lautenberg.senate.gov

The Honorable Robert Menedez
c/o Jason Lallis, jason_lallis@menendez.senate.gov

The Honorable Frank LoBiondo
c/o Laura Nolan, laura.nolan@mail.house.gov

The Honorable Robert E. Andrews
Via fax: 202.225-6583

New Jersey Bankers Association
c/o Michael Affuso, maffuso@njbankers.com

---

[2] Federal Reserve Board, "Commercial Bank Examination Manual," Interest-Rate Risk Management, §4090.1 - page 1, October 2007.